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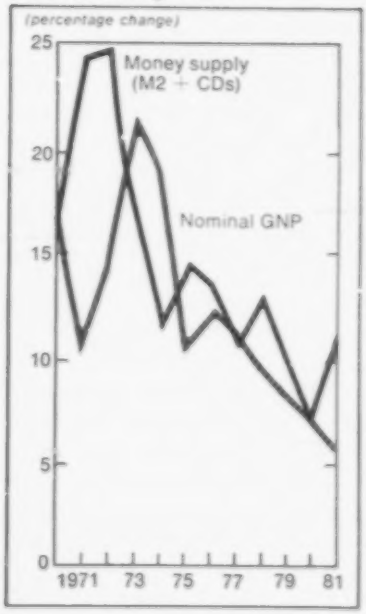
Japanese Monetary Policy Suggests Weak Yen

Recent and targeted money growth in Japan has cast some doubt on the validity of the current consensus forecast for 1982—especially regarding the outlook for the yen. According to private forecasters, the Japanese economy is likely to record real growth of 3%-4% this year, about the same as the estimated 3.2% growth of 1981. In addition, consumer-price inflation is expected to moderate to 3%-4% from 4.9%, the current account surplus is projected to widen sharply to perhaps $15 billion from the $4.7 billion surplus of 1981, and the yen is expected to appreciate to below 200 yen per dollar by yearend. These projections seem less plausible, however, when juxtaposed with the current stance on monetary policy.

In an attempt to spur domestic demand, the Japanese monetary authorities have pursued a relatively expansionary monetary policy since early 1981. As a result, M2 (currency and demand and time deposits) plus certificates of deposit (CDs) grew at an 11% rate between yearend 1980 and yearend 1981. Furthermore, the monetary authorities have continued this expansionary monetary policy, announcing a target growth rate for M2 plus CDs of 11% (at an annual rate) for the first quarter of 1982. This money growth, however, is considerably in excess of the recent and forecast growth in nominal GNP of 6%-7%. Any excess supply of money that results will require an equilibrating adjustment that has several important implications for the performance of the economy, and for the yen in particular.

Japan's monetary and economic growth



With the liberalization of the Japanese capital markets in December 1980, the excess supply of money arising last year was manifested in low real interest rates relative to those in the United States and then dissipated primarily through an outflow of capital. As a result, the yen was relatively weak, averaging 220 yen per dollar in 1981, and the deficit on capital account soared to $7.3 billion from only $1.6 billion in 1980. Over 1982, if the relatively expansionary monetary stance is maintained, the capital account may continue to be the primary outlet for an excess supply of yen.

Another possibility—but one that currently seems less certain—is that a disequilibrium in the Japanese money market could be alleviated partially through increased purchases of domestic or foreign goods and services. This would raise either real output or domestic prices and would result in a smaller-than-expected current-account surplus. In any event, an excess supply of money in the Japanese economy seems likely to lead to a weaker yen in 1982 than is now being predicted by most private forecasters.

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Upcoming British budget unlikely to contain expansionary measures.

In spite of Britain's 12.3% unemployment rate and another 2% decline in real GDP in 1981, the Thatcher government shows no signs of softening its stance on economic policy. Consequently, the new budget, due to be announced next week, is likely to contain little that might give a fiscal boost to the economy, other than perhaps an indexing of the tax system to take account of recent inflation—still stubbornly at 12%. As a result, the economy is likely to stay close to the trough of its recession and GDP will grow by somewhat less than 1% in 1982. The budget and the resultant course of the economy should attract renewed interest in sterling, however, as the inflation rate is likely to begin to come down over the year and the balance of payments is expected to remain in substantial surplus.

Recession poses dilemma for monetary policy in Switzerland.

Economic activity in Switzerland has been contracting since mid-1981. Retail sales volume has been running some 1%-2% below last year's level, industrial production has been flat, and labor market indicators have also confirmed the overall picture of economic weakness. The Federal Commission, in line with most private forecasters, now expects real GDP to decline by some 1.5% in 1982, following growth of 1% last year. This poses a policy dilemma for the Swiss National Bank (SNB). Domestic labor costs are rising sharply and despite strong opposition, the SNB would like to retain its current tight monetary policy to prevent a further step-up in inflation. Certainly the SNB will wish to avoid any further appreciation of the Swiss franc in terms of the German mark, since this would seriously impair export competitiveness. Thus, Swiss policy initiatives are likely to mirror developments in Germany. If U.S. interest rates turn down shortly, this would weaken the dollar and prompt some easing in German monetary policy. Swiss interest rates could then fall rapidly, as the SNB is prepared to accept franc weakness in terms of the mark.

Declining oil output likely to mean lower tax revenues for Norway.

Norway's output of oil and gas fell in 1981 to 48.8 million tons from 49.5 million in 1981, marking the first decline since the country began production. The current glut on the world's oil market has prompted huge downward revisions in the government's oil-price and production forecasts and a scaling back of anticipated tax receipts. Tax-revenue projections for 1982-85 have been reduced by more than 40%—down to kr. 100 billion from kr. 170 billion originally forecast. This suggests that the ruling conservative party may have difficulty in making the generous tax cuts promised during its election campaign. Moreover, another wage-price spiral is threatening to emerge. Prices have jumped 3% with the lifting of the price freeze imposed last August, bringing the year-on-year inflation rate back up to 12%. Nevertheless, the Norwegian outlook still looks favorable. Even if oil prices do fall still further, Norway's enormous oil stocks will continue to ensure the country substantial income and one of the highest standards of living in the world.

Uruguay's economy subdued, but strides made in moderating inflation.

Following two years of strong growth, the Uruguayan economy moved into a slowdown phase in 1981. Preliminary estimates indicate real GDP grew only 1% last year, after robust growth of 8.5% and 4.7% in 1979 and 1980, respectively. Large currency devaluations and recession in neighboring Argentina have contributed to the sluggishness, as have soft prices and depressed markets for Uruguay's beef and wool exports and complaints by exporter groups that the Uruguayan peso is overvalued. In real terms, the agriculture, cattle, construction and commerce sectors declined last year and manufacturing grew by only 1%. On the bright side, however, the Uruguayan authorities have had notable success in reducing the rate of consumer price increases from 43% at end-1980 to 29% at end-1981 by following the policy of devaluing the currency below the inflation rate. The government is hoping to eventually bring domestic inflation down to international levels but plans to ease the exchange-rate policy a little by allowing a slight monthly increase in July and August of this year. This may help exports somewhat but the overall rate of economic activity is likely to remain subdued.

Argentine authorities adopt tough stance to bring down inflation.

The Argentine government is pursuing a difficult stabilization program designed to reduce strong inflation expectations in the economy. Despite an already weak economy—real GDP fell 6% in 1981—policymakers have adopted a bold plan to hold constant the public-sector wage bill through the first quarter of 1982. Since wages account for more than half of government spending, the intention is to bring down the public deficit and the consequent need for central bank financing. The hope is that this will lead to slower growth of the money supply and thus a lower rate of inflation. Corrective increases in public service charges boosted the inflation rate up to an annual rate of 146.8% in January, but this jump had been anticipated by the authorities. By curbing public spending, the government believes the rate of inflation will gradually decline in subsequent months and finish below 100% by the end of 1982.

Depressed commodity prices leave Malaysia with gaping current-account deficit.

Like most commodity-dependent Asian economies, the performance of the Malaysian economy in 1981 was strongly influenced by the recession in the industrialized countries and the resultant steep decline in commodity prices. Real growth is estimated to have slowed to 6%-7% from 8% in 1980, despite efforts to support domestic activity through government spending. At the same time, inflation rose to near 10% from 7.8% the previous year. The trade account, which was in surplus by $2.3 billion in 1980, is likely to have turned into deficit as the prices for Malaysia's main commodity exports plunged. As a result, the current-account deficit is estimated to have widened to about $2.6 billion from $471 million in 1980. This year, ambitious government spending is expected to maintain real growth in the 6%-7% range. Inflation, however, is likely to remain around 10%. And with little recovery in commodity prices expected before the end of 1982, the current-account deficit could easily mount to well over $3 billion as the trade and service accounts continue to deteriorate.

Inflation-fighting tack slows Taiwanese economic growth.

Government efforts to stabilize prices set off a major growth slowdown in Taiwan in 1981. Although the real growth of 5.5% estimated for the year is quite respectable by international standards, it is a far cry from the 10.4% average of the previous five years. The government's tight money and credit policies did cut consumer price inflation in half to about 9.5% in 1981 from 19% the year before. But industrial production suffered as a result. Especially troublesome was low private investment, particularly in new projects. Earnings also declined drastically in some capital-intensive industries, such as petrochemicals, which faced slack world demand as well as high materials costs. Trade, however, was good and the trade balance moved into surplus by $1.4 billion in 1981, according to preliminary estimates. The outlook for Taiwan suggests stronger growth in 1982. Already the new cabinet formed in December has adopted a number of investment-boosting measures, indicating a shift back to a high-growth strategy in contrast to the previous team's emphasis on price stability.

Capital spending giving boost to Bahrain's economy.

Despite declining oil production, the Bahraini economy is continuing its recovery from the slowdown of 1979. Official statements have intimated renewed growth averaging about 5% in 1980 and 1981, with the major impetus stemming from an increase in government capital spending. The minister of finance recently outlined a $7 billion program for 1982-85 which strongly emphasizes infrastructure, especially power generation and water desalination. Meanwhile, good progress is being made on a number of heavy industrial projects involving inter-Arab cooperation and use of local gas resources. In addition, the long-planned Bahrain-Saudi Arabia Causeway is finally about to become a reality. The construction contract has been awarded to a Saudi-Dutch consortium and initial dredging has begun even though the project could take five years to complete. Although the long run impact of the causeway is a matter for debate, over the shorter run, the construction activity should provide positive support to the Bahraini economy.

Investment Unlikely to Boost Economy

If there was a silver lining at all in the revision of the fourth quarter GNP statistics, it was the better-than-expected performance of real business investment. Preliminary data had shown an 11% decline; however, this figure was revised, indicating only a 5.3% decrease—just slightly greater than the revised 4.7% decline in overall GNP. In contrast, during the second quarter of 1980, real GNP dropped 9.9% while fixed investment plunged 19.9%. But before too much optimism emerges about investment propping up the economy or leading a sustainable recovery, some words of caution are in order.

Real business-fixed-investment in both 1980 and 1981 was below its 1979 level. The usual excuse given for this weak performance is the persistently high levels of interest rates. Some analysts have likened the currently high rates to a hurdle that must be overcome before investment will proceed. Along this line of thinking, it has been argued that the business tax cuts via accelerated depreciation more than offset this hurdle, therefore, more investment should take place.

This argument, however, has two basic shortcomings. One deals with interest rates, the other with the firm's cash flow. High interest rates by themselves are not necessarily a barrier to investment. If demand conditions are such that a firm's expected rate of return exceeds the interest rate, then the investment will still take place.

As it turns out, interest rates *have* risen in the last two years. In fact, the rise has been large enough that interest rates now substantially exceed the rates of return on investment that can now be earned in many industries. To correct this imbalance, either investment must fall—that is, there must be a reduction in the capital stock by writing off obsolete and inefficient plant and equipment—or investment possibilities must be improved through technological innovation.

On the other hand, the increase in cash flow that the corporate sector will receive from the accelerated depreciation legislated last year will not completely offset the impact of higher interest rates. Firms have at least three uses for cash flow: dividends, fixed investment, and other investments (inventories, liquid assets, buying back debt or equity). It seems unlikely that an increase in cash flow would go entirely into any one category on an economy-wide basis. However, an individual firm might well decide to forego fixed investment entirely if none of its physical investment opportunities have a sufficiently high rate of return. Investment in Treasury bills, or the repurchase of outstanding debt—both with an assured profitable return—or an increase in the firm's dividend payout might well be more attractive alternatives.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit lions of
Argentina	Economy is in a recession with strong inflationary pressures and high unemployment.	Mar.	— 8%	117.0	$4,333	Oct.	3,473	—55%	4.8	0
Bolivia	New law passed to guarantee company operations and promote foreign investment.	Sept.	— 6%	6.1	1,090	Dec.	100	— 6%	1.3	71
Brazil	Some recuperation of business activity in January, especially in consumer goods purchases.	Nov.	+ 6%	233.2	1,896	Dec.	6,602	+14%	3.4	0
Chile	Government able to grant open-ended mining concessions to private investors under new law.	Oct.	—20%	22.8	2,060	Dec.	3,214	+ 3%	5.3	49
Colombia	Economic growth slowed to 3.2% in 1981 from 4% in previous year.	Sept.	—33%	36.8	1,360	Dec.	4,731	— 2%	11.3	0
Costa Rica	Central government budget deficit lowered to 5.6% of GDP in 1981 from 7.9% in 1980.	Aug.	+14%	4.6	2,063	Dec.	131	—10%	1.2	103
Ecuador	Economy slowing in response to fiscal and monetary restraints.	May	— 9%	11.0	1,321	Dec.	752	—26%	4.0	0
El Salvador	Government's 1982 budget at $844 million is only 6% higher than 1981—smallest rise in 10 years.	Aug.	—39%	3.3	690	Dec.	72	— 7%	0.8	44
Guatemala	Recent increases rescinded for internal prices of sugar cane and refined products.	Dec. '80	+ 1%	7.8	1,073	Dec.	150	—66%	1.0	111
Guyana	Sugar production being affected by shortage of harvesting machines.	June	+11%	0.6	635	Dec.	7	—46%	0.2	86
Honduras	One-third of $125 million in foreign loans in 1981 went toward housing.	Aug.	— 3%	2.4	651	June	112	—48%	1.4	38
Jamaica	Government reviewing investment proposals with potential value in excess of $1 billion.	Nov.	— 1%	2.4	1,096	Nov.	154	+57%	1.3	470
Mexico	Peso devaluation accompanied by 3% public budget cut, but wage demands could rise.	June	+40%	186.3	2,591	May	3,321	+38%	1.6	0
Nicaragua	State petroleum company established to distribute and sell products, explore new deposits.	Dec.	+28%	2.1	780	Dec. '80	70	—53%	1.1	25
Paraguay	Increased taxation effort is underway to reduce public sector budget deficits.	Oct.	— 4%	4.4	1,429	Dec.	806	+ 6%	18.1	0
Peru	Newly discovered deposits boost proven oil reserves to 900 million barrels; exploration intensifies.	Sept.	—17%	17.0	955	Nov.	1,028	—47%	2.3	383
Uruguay	Inflation rate decelerated in December but economy is also slowing.	Aug.	+32%	9.8	3,379	July	403	— 5%	2.9	0
Venezuela	New law requires public sector to purchase locally produced goods and services when available.	Oct.	+ 9%	60.4	4,345	Dec.	8,164	+24%	8.9	0

Reevaluating the M1 Upsurge

Recent economic data confirm the widespread view that the last three months' surge in money growth was not indicative of a rebound in total spending. Rather, the economy continued to weaken considerably through January. Such behavior is in marked contrast to previous periods of rapid money growth, during which total spending generally picked up along with the acceleration in money growth.

In November, December, and January, M1 grew at seasonally adjusted annual rates of 10%, 13%, and 23%, respectively. Such growth is similar in magnitude to that during the summer of 1980, when M1 grew at annual rates of 11½%, 14%, and 25% in June, July, and August, respectively. At the time it was widely believed that the economy would continue to be weak, and that the surge in money growth was some temporary aberration. As the economic data for this period became available, however, it turned out that total spending had already rebounded from that spring's very weak level. Over the summer, both retail sales and total business sales grew at annual rates of about 22%, and personal income rose by 13%.

The experience of 1980 led some forecasters to believe that the jump in money growth which began last November was an indication that total spending was rebounding much more sharply than had been anticipated. It is now apparent, however, that no such rebound occurred. In the November 1981-January 1982 period, personal income rose at an annual rate of only 3%, and both retail and total business sales fell.

It appears, then, that the indicator value of M1, while perhaps good in 1980, has been deficient of late. And yet the effect of money growth on interest rates in the two periods was the same: rates moved up significantly in response to rapid money growth. Indeed, in the recent period rates moved up more rapidly in response to the money bulge than they did in 1980—in part because of the memory of the 1980 experience. And it has only been very recently that rates have moved down somewhat—in part because the economy continued to weaken significantly despite the surge in money growth.

Unfortunately, none of this explains *why* money grew so rapidly in the first place. One hypothesis is that the severely weakened economy has caused the demand for "precautionary" money balances, or "liquidity," to rise dramatically. While this explanation certainly cannot explain all of the money bulge, it may have some validity. Indeed, the fact that 60% of the rise in M1 since last October was in the "other checkable deposits" category—which is composed of consumer transactions deposits similar to savings accounts—suggests that some consumer liquidity-building may have occurred. If this is the case, the recent monetary experience may be laying the groundwork for stronger consumer spending in coming months.

PAYMENTS		MONEY AND BANKING						COUNTRIES
? IMF , mil- dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars February 24, 1982	change from year earlier	current monetary conditions	
	Peso exchange rate holding steady.	Jan.	+147%	Oct.	+127%	.0001	−81%	Some decline in interest rates expected.	Argentina
	Currency devalued in effort to improve external accounts.	Sept.	+ 33%	Oct.	+ 20%	.0227	−47%	Monetary policy is restrictive.	Bolivia
	Devaluation rate in line with inflation.	Jan.	+ 95%	Nov.	+ 66%	.0073	−51%	Money supply accelerated in January.	Brazil
	Domestic recession likely to hold current-account deficit near 1981 level.	Dec.	+ 10%	Sept.	+ 17%	.0263	− 3%	Liquidity is at low level.	Chile
	Government plans to control non-essential imports.	Nov.	+ 26%	Apr.	+ 35%	.0195	−13%	Monetary policy is restrictive.	Colombia
	Current-account deficit was $390 million in 1981, vs. $660 million in 1980.	Sept.	+ 41%	Apr.	+ 37%	.0589	n. a.	Tight credit policy continues.	Costa Rica
	Brazil becomes largest buyer of Ecuadorean oil.	Oct.	+ 16%	July	+ 21%	.0295	−19%	Monetary Board raises interest-rate ceilings.	Ecuador
	Coffee crop in 1981-82 down 22% from year ago.	Sept.	+ 13%	Oct.	0	.4045	n. a.	Net international reserves continue to decline.	El Salvador
	International reserves continue to decline.	Aug.	+ 12%	Sept.	+ 4%	par	0	Net foreign assets on the decline.	Guatemala
	Net international reserves are negative.	July	+ 20%	June	+ 9%	.4000	+ 2%	Net foreign assets shrinking.	Guyana
	External prospects negatively affected by low commodity prices.	Oct.	+ 10%	Sept.	+ 1%	.50018	0	Net foreign assets declining.	Honduras
	IMF stand-by targets being met.	Nov.	+ 5%	Sept.	− 22%	.5700	+ 1%	Monetary policy continues restrictive.	Jamaica
	Central bank no longer supporting currency.	Jan.	+ 31%	Aug.	+ 54%	.0275	−36%	Domestic interest rates being kept at high levels.	Mexico
	Major sugar plantation and refinery project in works to bolster export capacity.	July	+ 28%	Dec.	+106%	n. a.	—	Foreign assets position worsening.	Nicaragua
	Timber exports off sharply.	Sept.	+ 10%	Sept.	+ 3%	.0082	+ 2%	Bank liquidity is at low level.	Paraguay
	International payments prospects worrisome in face of large fiscal deficit.	Nov.	+ 72%	Oct.	+ 48%	.00205	−29%	Domestic credit expanding rapidly.	Peru
	Faster devaluation scheduled for July-August.	Dec.	+ 29%	Aug.	+ 33%	.0875	−13%	Central bank trying to reduce interest rates.	Uruguay
	Government attempting to diversify sources of external finance.	Dec.	+ 11%	Aug.	+ 7%	.2334	0	Interest rates adjusting to liberalized environment.	Venezuela

World Interest Rates

market rates of Feb. 24, 1982; bond yields as of Feb. 19, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	16.50	13.7187 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.50	6.00	5.50
Day-to-Day Money	13.25 February 25	15.50	14.50	15.00	14.50	10.05	20.50	9.50	13.50	6.4375
Treasury Bills 91-day, Middle Rates	11.98 discount basis	14.40	13.375	14.25	n. a.	n. a.	19.302 90-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	12.50 finance paper discount basis	14.65 finance paper 15% tax w/h	12.57	13.90 Certified	14.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.25	14.70 15% tax w/h	13.9375	13.90 Certified	not traded	9.90	22.60	no market	8.25	no market
Government Bonds Long-term, new and old issues, average yield	14.05	15.50	14.08	10.943 20% tax w/h	15.97	9.79*	20.66	10.89	5.52	7.57
Industrial Bonds prime, long-term, new and old issues, average yield	15.00 Aa Industrials	17.00	15.84	16.723	17.09	9.82*	20.46	11.73	6.35	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	16.50	15.00	18.00	15.95	14.00	22.50 ¼ qtrly fee on outstdng.	12.00	10.5625	6.00
Bank Time Deposits 3-month	13.375 Cert. of Dep.	15.16	14.00	13.75	14.625	10.05	10.75	10.25 large deposits	8.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.00	no market	14.0625	no market	15.6875	10.25	no market	10.00	8.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8207	1.8955	.0232	.1658	.4228	.000788	.3853	.5336	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.049 *P*	1.14 *P*	.10 *D*	.0003 *D*	4.82 *P*	6.00 *D*	4.97 *P*	6.67 *P*	8.41 *P*

Eurodollar Deposits
(London, interbank, bid)
February 25

7-day	13.75
1-month	14.375
3-month	14.875
6-month	14.9375

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.351
U.S.-Canada Treasury Bills	−1.796
U.S.-Canada Finance Co. Paper	−1.998
Eurodollars-U.K. Local Auth. Deposits	+ .11

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.625
Over 7 yrs.	15.8125
DM Bonds	
7 yrs. and under	9.875
Over 7 yrs.	9.625

Gold Price
London afternoon fixing
362.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of February 12, 1982.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Jan.) 8.4	(Jan.) 11.4	(Jan.) 12.0	(Dec.) 14.0	(Jan.) 6.3	(Jan.) 17.3	(Jan.) 6.1	(Dec.) 4.3
Industrial production*	(Jan.) −8.1	(Nov.) −2.9	(Dec.) −1.2	(Dec.) 0	(Dec.) 0.5	(Dec.) 0.1	n.a.	(Dec.) 4.3
Trade balance† *(billions of local currency units)*	(Dec.) −$1.59	(Dec.) C$0.75	(Dec.) £0.33	(Dec.) −FF7.93	(Jan.) DM1.11	(Dec.) −Lit.1,090	(Jan.) −SF0.24	(Dec.) ¥484
Money supply (M1)*	(Jan.) 7.3	(Dec.) −1.9	(Nov.) 10.7	(Oct.) 16.4	(Dec.) −0.9	(Oct.) 8.0	(Nov.) −7.2	(Nov.) 8.3
Velocity of money (M1)*	(Sept.) 10.7	(June) 6.7	(March) 4.1	n. a.	(Sept.) 5.1	(Sept.) 4.4	n. a.	(June) 2.7
Reserves minus gold *($ million, change from previous month)*	(Dec.) −930	(Dec.) −164	(Dec.) −327	(Dec.) 425	(Dec.) −926	(Dec.) 1,575	(Dec.) 3,550	(Dec.) −373

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The Mexican Devaluation: Lessons from the Past

The de facto devaluation of the peso upon the announcement on February 18 that the Bank of Mexico would no longer support the currency in the foreign exchange market immediately conjured up memories of the 1976 peso devaluation—and of the debilitating economic events that followed. After a doubling of the peso/dollar rate in 1976, the Mexican economy lapsed into a period of market instability and upward price adjustment, followed by austere policies and slow growth. There are enough similarities between the economic environments contributing to the two devaluations to evoke feelings of *déjà vu* and concern for what the recent action implies for the Mexican economic outlook.

Since the peso established itself at a rate of 22 to 23 to the dollar after the 1976 action, Mexico has ostensibly conducted a managed floating-exchange-rate regime. In reality, however, this managed float has had properties of a fixed-rate system. The magnitude of the peso's recent devaluation against the dollar—over 40%—indicates how untenable this type of policy had become. In 1982 as in 1976, the decision to let the peso float was brought about by economic rather than political forces. In essence, the move represented an acknowledgement by the authorities that it was no longer economically viable to peg the exchange rate when the market was demanding an adjustment. Politically, the monetary authorities in Mexico, as in other countries, have the primary responsibility for exchange-rate management. Nevertheless, it is the aggregate supply and demand for a currency—inside a country and out—that determines its value, whether under fixed- or floating-exchange-rate systems.

In 1976, the Mexican devaluation occurred because there was a buildup of an excess supply of pesos. Within Mexico there was a strong desire to shift out of pesos and into dollars, and consequently, a heavy flow of capital out of the country took place. The recent devaluation occurred for much the same reason. Understanding the events leading up to and following that earlier devaluation should shed some light on the economic forces currently at work.

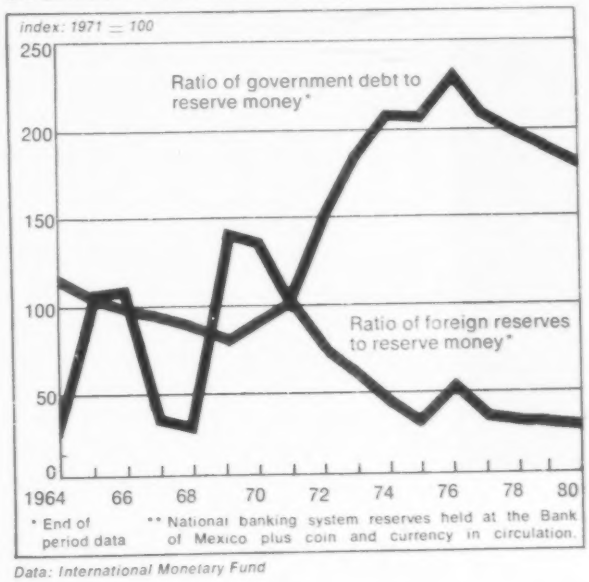
The history of the 1976 devaluation

Prior to the 1976 devaluation, Mexico essentially continued to operate as if it were in a fixed-exchange-rate world, despite the system of managed floating exchange rates that emerged after the breakdown of Bretton Woods in the early 1970s. At the same time, the country was being buffeted from the outside by worldwide inflation and from the inside by a fundamental change in economic policy that sent shocks throughout the Mexican monetary sector.

In the early part of the decade, the relatively expansionary monetary policies of the United States fed large flows of capital into the rest of the world. This created inflationary pressures, which the Mexican authorities attempted to reverse with a restrictive monetary stance in 1971. The government's anti-inflationary tactics proved to be ineffective, not only because the fixed exchange rates allowed the excess demand for money to be satisfied with dollars, but also because the political consequences of a tight domestic monetary policy could not long be tolerated. The restrictive measures had slowed economic growth much more rapidly than had been anticipated, and there were strong pressures for the adoption of a more stimulative policy. The government enacted expansionary expenditure and investment programs, but at the same time held fast to the inelastic fiscal revenue structure inherited from the development policies of the 1950s and 1960s. The result was a huge increase in the federal deficit. By 1975 federal government expenditures had risen 300% over the 1971 level and the deficit equaled about 5% of GDP. This presented the Mexican monetary authorities with a dilemma: The deficit had to be funded, either through expanded foreign borrowings, or domestically through increased debt to the private sector or by the stepped-up printing of pesos.

Much of the deficit was financed by foreign borrowing. But the bulk of the responsibility for financing

Sources of Reserve Money in Mexico**



Data: International Monetary Fund

The Mexican Devaluation: Lessons from the Past *(continued from page 7)*

the deficit internally fell to the Mexican monetary authorities—indirectly through financial intermediaries or directly by money creation. Mexico had created an ingenious system for funding the public debt through reserve requirements on financial intermediaries during the 1960s, when these services were expanding rapidly. In the early 1970s, however, owing partly to the monetary authorities' lack of success in containing inflation and to an increasing awareness that the federal deficit could not be financed without additional money creation, this type of financing became more difficult. The rate of demand for savings by the private sector declined as portfolio adjustments were made to protect against higher inflation. Domestic savings decreased in real terms, shrinking the central bank's capacity for funding the deficit through financial intermediaries. And with capital flight beginning, this left money creation as the only alternative.

Domestic credit grew some 30% in 1973, accelerated to 40% growth in 1974, and by 1975 was expanding at an annual rate of 50%. This high growth in domestically created money was about double the rate of growth in demand for those funds, causing an excessive buildup in the supply of pesos. This created pressures that had to be relieved through an outflow of reserves, given Mexico's intent on maintaining a fixed exchange rate.

According to the principles of the monetary approach to international adjustment, the Mexican authorities could maintain a given exchange rate through an intervention policy, until they depleted their supply of the intervention currency—U.S. dollars. Throughout the 1950s and into the 1960s, the Mexican authorities consciously maintained the share of the monetary base denominated in dollars or gold at a high level. In 1958, for example, foreign assets were 55% of reserve (or base) money. In 1966, they were still at 40% of reserve money. By 1975, however, the ratio had fallen to only 14% (see chart, preceding page). Thus, the stage was set for a devaluation. If Mexico had been willing to accept a flexible exchange rate, the pressure of the excess supply of pesos on reserves would have been replaced by pressures on prices and/or the exchange rate, and there would have been no reason for reserves to flow out of the country. But the groundwork for a downward adjustment in the exchange rate had been laid over 1973-75. And as pressures began to mount, the public responded with capital flight. Given the environment, and given that the financing needs of the government had to be satisfied via an expansion of the domestic money supply, the Bank of Mexico was left with no other choice but to devalue.

The devaluation experience

The 1976 devaluation experience itself may include policy lessons applicable to Mexico in the near term. Following the de facto adjustment on September 1, 1976, the peso was floated for a period until it reached 19.5 pesos per dollar. At that rate the Bank of Mexico unilaterally repegged it. In doing so, it created an almost risk-free speculative situation, or in essence, provided Mexican citizens a vehicle to avoid another devaluation. The "dollarization" process then began. Citizens swapped pesos for dollars in their portfolios until eventually the Bank of Mexico depleted its reserves of dollars. The peso was once again floated, but by this time its "credibility" had been greatly damaged. It was some time before the rate stabilized in the 22-to-23-pesos-per-dollar range. In the interim there was an extended period of financial uncertainty and instability. This finally ended with assurances brought by the restrictive policies of the then-new President Lopez Portillo.

Although the lessons learned from the 1973-76 experience have not gone unheeded over the last few years, policy choices were made that ensured that the 1982 devaluation was inevitable. Fiscal deficits grew and had to be financed by money creation, which once again led to capital flight, dollarization, a decrease in the ratio of foreign assets to reserve money (down to 13% in 1980), and, within Mexico, an increasing belief that the peso was overvalued. This situation could not last indefinitely and the peso had to adjust. Now, almost six years later in the aftermath of another sizable devaluation, two questions arise: Will the peso experience another period of instability and uncertainty similar to late 1976? And will the government once again have to reinstate a tough monetary and fiscal policy in order to stabilize the peso?

The economic prospects for Mexico in 1983 and 1984, under a new president, will depend critically upon the policies that Mexico chooses to back this recent devaluation. Policy adjustments already in place will be tested as Mexican citizens attempt to protect themselves against inflation. Furthermore, policy adjustments must be keyed to controlling the creation of domestic credit—an intention of the authorities. This implies decreasing the fiscal demands upon the central bank to create that credit. This may not be an easy task. Nevertheless, the 1976 and 1982 devaluations have already provided two lessons that a stable peso and expansion of domestically created money are not consistent.

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